D. IRC 512(b)(13) - CONTROLLED ORGANIZATIONS

1. Introduction

One of the recent trends in the area of exempt organizations is an increasing number of subsidiaries created by organizations exempt under IRC 501(c). Hospitals, which are exempt under IRC 501(c)(3), have led the way by establishing both nonprofit and for-profit subsidiaries as part of various reorganization plans. Other organizations, such as those engaging in research activities, have joined the parade of nonprofit tax-exempt organizations with subsidiaries, and the proliferation of such entities does not seem to be abating. With the appearance of subsidiary organizations, the question arises as to what tax consequences might be attendant upon the controlling parent exempt organization. In the context of unrelated business taxable income, IRC 512(b)(13) contains rules that directly affect exempt organizations with so-called "controlled organizations."

Last year's CPE text, at page 37, contained a discussion of "IRC 512(b)(13) in a Nutshell" as part of the topic "For-Profit Subsidiaries of Tax-Exempt Organizations." The purpose of this year's topic is to present a somewhat more in-depth discussion of IRC 512(b)(13), while presenting some hypothetical situations and answering at least one of the questions posed in last year's text.

2. Background

A. Code Provisions

IRC 511(a)(1) imposes a tax on the unrelated business taxable income of certain state colleges and universities and organizations described in IRC 401(a), and IRC 501(c). IRC 512(a)(1) defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business (as defined in IRC 513) regularly carried on by it, less deductions, and with the modifications provided in IRC 512(b). This may be considered the general rule with respect to imposing tax on the unrelated business income of exempt organizations. The modifications contained in IRC 512(b), in effect, constitute an exception to the general rule by excluding from the computation of unrelated business taxable income items such as dividends, interest, annuities, royalties and rents. If these modifications, which are provided in IRC 512(b)(1), (2), and (3), are considered an exception to the general rule of taxing the unrelated business income of exempt organizations, then IRC 512(b)(13) may be considered an exception to the exception. Under IRC 512(b)(13), the exclusion of interest, annuities, royalties, and rents provided by IRC 512(b)(1), (2), and (3) does not apply where such amounts are derived from "controlled organizations."

Congress amended IRC 512(b)(13) (formerly IRC 512(b)(15)) as part of the Tax Reform Act of 1969 (Pub. L. 91-172). The statute itself reads as follows:

> (13) Notwithstanding paragraphs (1), (2), or (3), amounts of interest, annuities, royalties, and rents derived from any organization (in this paragraph called the "controlled organization") of which the organization deriving such amounts (in this paragraph called the "controlling organization") has control (as defined in section 368(c)) shall be included as an item of gross income (whether or not the activity from which such amounts are derived represents a trade or business or is regularly carried on) in an amount which bears the same ratio as -
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> (A)(i) in the case of a controlled organization which is not exempt from taxation under section 501(a), the excess of the amount of taxable income of the controlled organization over the amount of such organization's taxable income which if derived directly by the controlling organization would not be unrelated business taxable income, or (ii) in the case of a controlled organization which is exempt from taxation under section 501(a), the amount of unrelated business taxable income of the controlled organization, bears to
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> (B) the taxable income of the controlled organization (determined in the case of a controlled organization to which subparagraph (A)(ii) applies as if it were not an organization exempt from taxation under section 501(a)), but not less than the amount determined in clause (i) or (ii), as the case may be, of subparagraph (A), both amounts computed without regard to amounts paid directly or indirectly to the controlling organization. There shall be allowed all deductions directly connected with amounts included as gross income under the preceding sentence.

B. Regulations

Reg. 1.512(b)-1(l)(1) essentially repeats the statutory provision, while noting that amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the unrelated business taxable income of the controlling organization, even though the rental of such property is not an activity regularly carried on by the controlling organization.

Reg. 1.512(b)-1(l)(2)(ii) contains the following two examples, which are applicable to exempt controlled organizations:

> Example (1). A, an exempt scientific organization described in section 501(c)(3), owns all the stock of B, another exempt scientific organization described in section 501(c)(3). During 1971, A rents space for a laboratory to B for $15,000 a year. A's total deductions for 1971 with respect to the leased property are $3,000: $1,000 for maintenance and $2,000 for depreciation. If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$ 100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	$ 300,000
Ratio ($ 100,000/$ 300,000)	1:3
Total rent	$ 15,000
Total deductions	$ 3,000
Rental income treated as gross income from an unrelated trade or business (1/3 of $ 15,000)	$ 5,000
Less deductions directly connected with such income (1/3 of $ 3,000)	$ 1,000

Net rental income included by A in computing its unrelated business taxable income	$ 4,000

Example (2). Assume the facts stated in example (1), except that B's taxable income is $90,000 (computed as though B were not an exempt organization, and disregarding rents paid to A). B's unrelated business taxable income ($100,000) is therefore greater than its taxable income ($90,000). Thus the ratio used to determine the portion of rent received by A which is to be taken into account is one since both the numerator and denominator of such ratio is B's unrelated business taxable income. Consequently, all the rent received by A from B ($15,000), and all the deductions directly connected therewith ($3,000), are included by A in computing its unrelated business taxable income.

Reg. 1.512(b)-1(l)(3)(iii) contains the following two examples, which are applicable to nonexempt controlled organizations:

Example (1). A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from a dormitory for students of A University and $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M's taxable income (disregarding rent paid to A)	$ 500,000
Less taxable income from dormitory	$ 150,000
Excess taxable income	$ 350,000
Ratio ($ 350,000/$ 500,000)	7/10

Total rent paid to A	$ 100,000
Total deductions ($ 4,000 + $ 16,000)	$ 20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $ 100,000)	$ 70,000
Less deductions directly connected with such income (7/10 of $ 20,000)	$ 14,000
Net rental income included by A in computing its unrelated business taxable income	$ 56,000

Example (2). Assume the facts as stated in example (1), except that M's taxable income (disregarding rent paid to A) is $300,000 consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus M's "excess taxable income" is also $300,000 since none of M's taxable income would be excluded from the computation of A's unrelated business taxable income if received directly by A. The ratio of M's "excess taxable income" to its taxable income is therefore one ($300,000/$300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A's unrelated business taxable income.

Most significantly, Reg. 1.512(b)-1(l)(4) discusses the issue of control. The regulation states that, for stock corporations, the term "control" means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. For nonstock organizations, the regulation states that "control" means that at least 80 percent of the organization's directors or trustees are either representatives of or directly or indirectly controlled by an exempt organization. The regulation further notes that a trustee or director is a representative of an exempt organization if he or she is a trustee, director, agent, or employee of the exempt organization. A trustee or director is controlled by an exempt organization if the organization has the power to remove the trustee or director and designate a new one. The regulation further notes that if control of an organization is acquired or relinquished during the taxable year, only interest, annuities, royalties, and rents paid or accrued during that portion of the taxable year it has control will be subject to the tax on unrelated business income.

Finally, the regulation notes that if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's unrelated business taxable income must first be determined under IRC 512(b)(13) and the regulations thereunder, and only the portion of rents not taken into account by operation of IRC 512(b)(13) are taken into account by operation of IRC 514. The regulation refers to the following example from Reg. 1.514(b)-1(b)(3):

> Example (3). (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971, M leases from Z University a factory unrelated to Z's exempt purpose and a dormitory for the students of Z, for a total annual rent of $100,000: $80,000 for the factory and $20,000 for the dormitory. During 1971, M has $500,000 of taxable income, disregarding the rent paid to Z: $150,000 from the dormitory and $350,000 from the factory. The factory is subject to a mortgage of $150,000. Its average adjusted basis for 1971 is determined to be $300,000. Z's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, IRC 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of IRC 512(b)(3) and not included in such computation pursuant to IRC 512(b)(13). Since all the rent received by Z is derived from real property, IRC 512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to IRC 512(b)(13), computed as follows:

M's taxable income (disregarding rent paid to Z)	$ 500,000
Less taxable income from dormitory	$ 150,000
Excess taxable income	$ 350,000

Ratio ($ 350,000/$ 500,000)	7/10
Total rent paid to Z	$ 100,000
Total deductions ($ 4,000 + $ 16,000)	$ 20,000
Rental income treated under section 512(b) (13) as gross income from an unrelated trade or business (7/10 of $ 100,000)	$ 70,000
Less deductions directly connected with such income (7/10 of $ 20,000	$ 14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(13)	$ 56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(13) may be included in computing unrelated business taxable income by operation of IRC 514, only $10,000 ($80,000 minus $70,000) of rent and $2,000 ($16,000 minus $14,000) of deductions are taken into account. The portion of such amounts to be taken into account is determined by multiplying the $10,000 of income and $2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness ($150,000) is of the average adjusted basis of the property ($300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of $150,000 to $300,000). Under these circumstances, Z shall include net rental income of $4,000 on its unrelated business taxable income for 1971, computed as follows:

Total rents	$ 10,000
Deductions directly connected with such rents	$ 2,000
Debt/basis percentage ($ 150,000/$ 300,000)	50 percent
Rental income treated as gross income from an unrelated trade or business (50% of $ 10,000)	$ 5,000

Less the allowable portion of deductions directly connected with such income (50% of $ 2,000)	$ 1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	$ 4,000

It should be noted that this example does not take into consideration the possible applicability of IRC 514(c)(9). This provision was enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369, July 18, 1984), and generally provides an exception to acquisition indebtedness for educational organizations described in IRC 170(b)(1)(A)(ii) that incur indebtedness in acquiring or improving any real property.

C. Legislative History

The House Report (H.R. Rep. No. 91-413, Part I, 91st Cong., 1st Sess. 49 (1969), 1969-3 C.B. 232), indicates that the amendment to IRC 512(b)(13) was designed to eliminate a potential loophole in the unrelated business income tax by preventing the following type of abuse:

> In certain cases exempt organizations do not engage in business directly but do so through nominally taxable subsidiary corporations. In many such instances the subsidiary corporations pay interest, rents, or royalties to the exempt parent in sufficient amounts to eliminate their entire income, which interest, rents, and royalties are not taxed to the parent even though they may be derived from an active business.
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> This problem is remedied under the bill by removing the exemption from the unrelated business tax for passive income if it is in the form of interest, rents, and royalties received from controlled corporations.

The Senate Report (S. Rep. 91-552, 91st Cong., 1st Sess. 73 (1969), 1969-3 C.B. 471), states the following:

> Present law. - Under present law, rent, interest, and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally is not subject to tax.

General reasons for change. - Some exempt organizations "rent" their physical plant to a wholly-owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction. While courts have occasionally disallowed some, or all, of the rent deductions, the issue is a difficult one for the Internal Revenue Service.

Explanation of provisions. - Both the House bill and the committee amendments provide that where a tax-exempt organization owns more than 80 percent of a taxable subsidiary, the interest, annuities, royalties and rents received by it are to be treated as "unrelated business income" and are subject to tax in the hands of the exempt organizations. The deductions connected with the production of this income are allowed.

The committee's bill modifies this provision slightly by providing that where the subsidiary is also an exempt organization, it is to apply only in the proportion that the subsidiary's income is unrelated business income to it. In addition, where the operation of a taxable controlled corporation is "functionally related" to the exempt purposes of the controlling exempt organization the committee amendments provide that income from the taxable subsidiary is to be treated as related income and therefore not subject to tax in proportion to the subsidiary's income from the functionally related activities. The committee believes that these modifications are appropriate, since, in the case of a controlled exempt corporation, there is no intention to tax its related income.

D. Court Cases

By amending IRC 512(b)(13) as part of the Tax Reform Act of 1969, Congress, in effect, overruled cases like United States v. Robert A. Welch Foundation, 334 F.2d 774 (5th Cir. 1964) and Amon G. Carter Foundation v. United States, 58-1 U.S.T.C. Par. 9342 (N.D. Tex. 1958), in which otherwise taxable "working interests" in oil and gas leases were "spun-off" in return for nontaxable royalties.

In Welch, an exempt foundation received income from two corporations of which the foundation was the controlling stockholder. The Court considered whether such income was derived from a working interest in oil and gas properties, or whether the income was received from overriding royalties. If the income was derived from a working interest in oil and gas properties, it would constitute unrelated business taxable income. If the income was received from overriding royalties, it would be excluded from the computation of unrelated business taxable income under IRC 512(b)(2). The Court of Appeals noted that the District Court determined that the contracts under which the foundation received the income in the form of overriding royalties ". . . did in truth and in fact, create income from overriding royalties and not income from working interests." In reviewing the contracts, the Court of Appeals stated the following:

> To us, the contracts seem clear and plain, and the evidence with respect to them makes them even clearer and plainer. It would deny to the facts their plain and compulsory meaning to hold that the form into which the payments were cast by the contracts and the action of the parties resulted in such payments being taxable income.

The Court rejected the Government's argument that the contracts, though framed as to create the appearance of overriding royalties, were in substance working interests. The Court concluded that the amounts involved were royalties and therefore not subject to the tax on unrelated business income.

In Rev. Rul. 69-162, 1969-1 C.B. 158, the Service announced that it would not follow the decision in Welch, but would continue to review exempt organizations' transfers of mineral properties to controlled corporations. The Rev. Rul. states that, if, in substance, the income received by an exempt organization is from a working interest, characterization of the income as "royalty" will not be accepted by the Service.

In Carter, an exempt foundation formed a corporation of which the foundation was the beneficial owner of all the corporation's capital stock. The foundation transferred oil payments, oil and gas leases, and other items to the corporation. As part of this transaction, the foundation retained overriding royalties in the oil and gas interests, while the corporation operated the businesses. The foundation received amounts paid as overriding royalties, interest, and payments on principal. No unrelated business income was reported by the foundation based on the theory that royalties, interest, and payments on principal were not subject to tax. The Service disagreed, asserting that the corporation had no separate existence and that the amounts involved were taxable as unrelated business income. The Court held that the subsidiary corporation had a separate and distinct existence, and the income derived from the operation of the corporation was not taxable to the exempt foundation as unrelated business income.

The Welch and Carter decisions, of course, preceded the Tax Reform Act of 1969, and are exactly representative of the kinds of abuses Congress sought to halt by amending IRC 512(b)(13). By removing the "passive income" exclusion in cases involving a controlled organization, Congress attempted to close a loophole which various organizations utilized with apparent judicial approval.

The scope of IRC 512(b)(13), in the context of overriding royalty payments, was addressed in The J.E. and L.E. Mabee Foundation v. United States, 533 F.2d 521 (10th Cir. 1976). In that case, a taxable corporation engaged in the production and sale of oil and gas through ownership of oil and gas leases. The corporation was a wholly-owned subsidiary of a tax-exempt foundation. The foundation, as the holder of the overriding royalty interests, received payments directly from the oil purchasers rather than indirectly through its subsidiary, which would have been the customary method of receiving such payments. The foundation, while admitting that the subsidiary was a "controlled organization," argued that the overriding royalties should be excluded from "unrelated business taxable income" because the income was not "derived from" the subsidiary within the purview of what is now IRC 512(b)(13) but rather form the oil purchasers directly.

The Court, describing the method of payment as a "scheme ... within the manipulations which Congress sought to tax," categorically rejected the foundation's position at 524:

> It is of no consequence that Foundation and Petroleum (taxable subsidiary corporation) had arranged for Foundation to receive the money directly rather than through Petroleum. Petroleum produces and markets the gas and oil to generate the production income upon which Foundation's overriding royalty income is based. Taxation does not depend on the mechanical formality of whether the overriding royalty income was paid through the controlled organization generating the income or directly to the charitable recipient. It appears clear beyond peradventure that Congress intended to tax a charitable organization's receipt of customary "royalties" from a "controlled organization." If the terminology "derived from" enhances that receipt, there appears no basis on which to contend overriding royalty

> income is not equally "derived from" a controlled organization operating a working interest.
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> This interpretation, subjecting the overriding royalty income of exempt organizations to taxation, jogs with the express legislative intent to tax passive income realized from "controlled organizations."

IRC 512(b)(13) is designed to prevent parent-subsidiary transactions from escaping taxation through sophisticated rent payment, as well as interest, annuity, and royalty schemes. Mabee Foundation clearly indicates that to effectuate the intent of Congress when it amended IRC 512(b)(13) and to prevent potential abuses, it is necessary to give that section a broad and expansive reading. Thus, where a tax-exempt organization attempts to circumvent the statute by structuring transactions so that payments are received from third parties rather than from its controlled organization, such manipulations will be ignored by the courts.

3. The Meaning of "Control"

Last year's CPE text at page 38 presented the question: "What is the Meaning of Control?" The article discussed the Code and regulations, the Mabee decision, and G.C.M. 38878, and concluded with the following:

> It is not known, however, how this principle would be applied in determining "control" under IRC 368(c) for purposes of IRC 512(b)(13) in a situation where, for example, a tax-exempt parent owned less than 80 percent of stock of an organization, if only its shares were counted, but would own more than 80 percent if shares of related organizations were included. Where such a situation exists, and the applicability of IRC 512(b)(13) is at issue, the case should be forwarded to the National Office for resolution.

During the past year, additional consideration has been given to the question of "control" under IRC 512(b)(13). As noted previously, IRC 512(b)(13) requires that control be defined under IRC 368(c). The regulations provide that, for stock corporations, control means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock of the corporation. IRC 368(c) is not within the jurisdiction of the Exempt Organizations Technical Division, but is administered by the Reorganization Branch of the Corporation Tax Division, which has published Rev.

Rul. 56-613, 1956-2 C.B. 212. This Rev. Rul. states that IRC 368(c) specifically defines control in terms of direct ownership of stock and not in terms of practical control. The Rev. Rul. states that there is no basis for disregarding the separate legal entities of the parent and its subsidiary, and for attributing the subsidiary's ownership of stock to the parent. Thus, we are no longer uncertain as to the result in a situation where the parent owns less than 80 percent of the stock of another organization, but would own more than 80 percent if the shares of related organizations were included. Under IRC 368(c), no control generally exists where one organization owns less than 80 percent of another organization's stock.

IRC 368(c) was redesignated as IRC 368(c)(1) and (2) as part of the Deficit Reduction Act of 1984 (P.L. 98-369, July 18, 1984). IRC 368(c)(1) now contains the general rule of control previously contained in IRC 368(c), while IRC 368(c)(2) sets forth a special rule for determining whether a transaction qualifies as a reorganization for purposes of IRC 368(a)(1)(D). Other sections of IRC 368(a)(1) are unaffected by the changes. Under IRC 368(c)(2), control is defined as having the meaning given such term by IRC 304(c), which means that control is defined as ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock. Ultimately, however, the special rule of IRC 368(c)(2) is not applicable to IRC 512(b)(13) issues, which will continue to be governed by the general rule of IRC 368(c)(1). An amendment to IRC 512(b)(13) might be necessary to expand the definition of control in order to prevent situations where parent organizations own less than 80 percent of a corporation's stock while other related organizations own more than 20 percent of the corporation's stock.

The issue of control will be discussed in some of the following hypotheticals.

4. Application of Principles

Consider the following hypotheticals:

A. Two Classes of Stock

Organization M is recognized as exempt under IRC 501(c)(3) and is classified as a supporting organization under IRC 509(a)(3). M is engaged in charitable, educational, and religious activities including the publishing of religious books and periodicals. M is a supporting organization of Organization N, a religious organization, which is also exempt under IRC 501(c)(3). Although M supports N, the two organizations are not related to the extent that the ownership of stock by N would be attributed to M. Organization O is a for-profit corporation engaged in the business of commercial printing. M owns all of the outstanding common stock of O, which is not currently authorized to issue another class of stock. O leases land and a portion of a building from M for a specified rental payment. O is also indebted to M on certain demand notes, bearing interest, which is paid by O to M. Because O is wholly-owned by M, M has treated the interest and rental payments received from O as unrelated business income taxable to the extent provided for in IRC 512(b)(13).

O proposed to authorize a class of preferred shares carrying a fixed dividend rate of seven percent per year, with dividends being paid out of current earnings as declared by the Board of Directors. Unpaid dividends will accumulate and the preferred shares will not be convertible into any other security. Preferred shares will have a dividend and liquidation preference over the common stock. Claims of preferred shareholders will be subordinate to those of creditors. Although preferred shares will have no stated voting rights, state law provides that the holders of the outstanding shares of the class may vote on amendments to the articles of incorporation that would affect the class in enumerated ways. State law also entitles holders of the preferred shares to vote on mergers under certain circumstances. There are no restrictions on the transfer of the preferred shares. Following authorization of the preferred shares, O will issue the preferred shares as a dividend to M. The value of the preferred shares is equal to ten percent of the stated value of the common stock. M will then contribute the preferred shares to N. Following this transfer M will own all of the issued and outstanding shares of common stock of O, while N will own all of the issued and outstanding preferred shares of O. This transaction is intended to benefit N, and to create a minority equity interest in O so that O will no longer be considered controlled by M within the meaning of IRC 512(b)(13) and IRC 368(c).

The Service position is that, after the proposed transfer of stock, amounts of interest and rental income received by M from O will not be considered unrelated business taxable income. The exclusion of interest under IRC 512(b)(1) and rent under IRC 512(b)(3) will be available to M. The provisions of IRC 512(b)(13) will no longer be applicable because O will not be a "controlled organization" with respect to M. O's preferred shares of stock will not be owned by M, but instead will be transferred to N, an entity that is separate and distinct from M. Although M will continue to own the outstanding common stock of O, for purposes of IRC 512(b)(13) and 368(c), it is necessary for the controlling organization to own at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock of the corporation. In order for O to be considered a "controlled organization" with respect to M following authorization of the preferred shares, it would be necessary for M to retain at least 80 percent of the new shares of stock.

B. Insulated Subsidiary

Organization A is recognized as exempt under IRC 501(c)(3) and is classified as a hospital under IRC 509(a)(1) and 170(b)(1)(A)(iii). A operates a medium sized hospital and provides various health care services to the surrounding community. As part of a hospital reorganization plan, A became part of a hospital system with newly created organization B as the parent organization. B was established to oversee the regional hospital system.

Organization C and Organization D are both for-profit corporations that are part of the hospital system. C was initially formed by A to hold investments in common stock and bonds. Income from these investments is used to pay dividends to A. D is a wholly-owned subsidiary of C. D was established to sell medical supplies to A and other area hospitals. D engages in purchasing, warehousing, and selling activities, as well as providing insurance to A and other hospitals. These activities are commercial in nature, and emphasize quick delivery, quality service, and low prices. All of D's common stock is owned by C. There is no preferred stock. C was wholly-owned by A prior to the reorganization, at which time C's stock was transferred to the newly created parent organization B. Prior to the reorganization, A received substantial amounts of income from D in the form of rent. Following the reorganization, A will continue to receive rental payments from D.

The question presented is whether D's rental payments to A may be excluded from the computation of unrelated business taxable income under IRC 512(b)(3), or whether the provisions of IRC 512(b)(13) result in the rental payments being subject to tax. A's legal representatives would advance the following argument:

> Admittedly, D is a controlled organization with respect to C, and C was a controlled organization with respect to A prior to the reorganization. Following the reorganization, C became a controlled organization with respect to B. Prior to the reorganization, the line of control between A and D was more direct, since D was a wholly-owned subsidiary of C, and C was a wholly-owned subsidiary of A. Nevertheless, because control under IRC 512(b)(13) and 368(c) is

> defined in terms of stock ownership, D's stock was owned by C, not by A, and therefore D was not a "controlled organization" with respect to A. Following the reorganization, the ownership of D is even more insulated from A, in light of C's stock being transferred to B. As a consequence of the reorganization, C and A have become brother-sister corporations, with C's wholly-owned subsidiary, D, continuing to pay rent to A. Under these circumstances, D is not a "controlled organization" with respect to an exempt organization, and therefore the provisions of IRC 512(b)(13) are inapplicable.

Service employees assigned to this case would attempt to rebut the argument of the taxpayer's representative by applying the rationale and conclusion contained in G.C.M. 38878. (G.C.M.'s are not citable authority, but may be useful as a source of legal analysis.) There, Chief Counsel discussed a hypothetical situation in which a tax-exempt parent organization controlled two wholly-owned subsidiaries: a tax-exempt hospital and a for-profit pharmacy and optical shop. The tax-exempt hospital leased space in its facility to the for-profit pharmacy and optical shop. Rental payments were made by the for-profit subsidiary directly to the tax-exempt subsidiary and not to their parent organization. The G.C.M., which did not discuss Rev. Rul. 56-613, cites the Mabee holding, supra, and states that it would be inconsistent and contrary to the purpose of IRC 512(b)(13) to tax a controlling exempt organization which receives rental payments directly from a wholly-owned taxable subsidiary but to ignore such payments merely because the controlling organization interposed another wholly-owned subsidiary between itself and the payments. The G.C.M. does note that, unlike the situation in Mabee, there is no indication in the hypothetical that the controlling organization is in actual receipt of the rental payments. Chief Counsel did not, however, view the absence of actual receipt of payments from the taxable subsidiary as determinative.

Applying this analysis to our own hypothetical, Service employees would argue that D's payments of rent would be subject to tax under IRC 512(b)(13) in view of the broad scope of the statute and the judicial precedent. The rental payments from a taxable subsidiary to a tax-exempt subsidiary, both wholly-owned by a tax exempt parent, should be deemed to have been received by the parent organization and subject to IRC 512(b)(13) in computing the parent's unrelated business taxable income. Further authority supporting this analysis can be found in Crosby Valve and Gage Company v. Commissioner, 380 F.2d 146 (1st Cir. 1967), cert. denied 389 U.S. 976 (1967). Crosby concerns an interpretation of IRC 512(b)(10) and stands for the position that to effectuate fully the intent of Congress in the unrelated business taxable income area, a wholly-owned entity interposed between the exempt controlling organization and the wholly-owned source of the payments may be disregarded.

The taxpayer's argument underscores the limitations surrounding the definition of control for purposes of IRC 512(b)(13) and 368(c). By focusing exclusively on stock ownership of corporations, the Code provisions seemingly preclude attribution of control in situations involving multiple corporations. Legislation would probably be required to expand the concept of control under IRC 512(b)(13) and to include practical, constructive control in addition to direct stock ownership. Consideration should be given to requesting technical advice on cases whose fact pattern is similar to that described in the hypothetical.

C. Applying the Formula of Reg. 1.512(b)-1(l)(3)

G.C.M. 39286 (as noted previously, G.C.M.'s are not citable authority) discusses another situation involving controlled organizations. Organization X is exempt under IRC 501(c)(3) and is described in IRC 509(a)(1) and 170(b)(1)(A)(ii). Corporations Y and Z are non-exempt corporations that were organized to build office buildings on property transferred to them by X. There is third party debt associated with each building, and X holds subordinate mortgages on the buildings. The buildings are rented to third parties and are not used for purposes related to X's exempt purpose or function. Y and Z were each 100 percent directly owned by X until ownership was transferred to another wholly-owned non-exempt corporation. Income accrued to X from Y and Z, but less than 20 percent of the accrued amounts were actually paid to X. Y and Z had net operating losses without regard to amounts paid or accruing to X. Also, Y and Z had interest income from certificates of deposit.

The question arises as to how to apply the formula of Reg. 1.512(b)-1(l)(3) for determining the amount to be included as an item of gross income. The formula itself is fairly complex and involves calculations based on a ratio. Reg. 1.512(b)-1(l)(3)(ii) contains examples in which the formula is applied. (See section 2.B of this article, supra.)

The difficulty arises in attempting to determine the amount of income included under the formula where the controlled corporations sustain net operating losses without regard to amounts paid to the controlling organizations. Under these circumstances, the taxable figure would be a negative amount. The G.C.M. states that where the controlled nonexempt organization has a net operating loss and all amounts are amounts that would be unrelated business taxable income if derived directly by the controlling exempt organization, the resulting ratio is one. In summary, the rule is that the number "1" is used for ratios resulting in a number greater than "1" for purposes of applying the formula of Reg. 1.512(b)-1(l)(3) in a net operating loss situation. Applying this rule to the case at hand, all amounts derived by X from Y and Z are included as an item of gross income under IRC 512(b)(13).

5. <u>Conclusion</u>

Although IRC 512(b)(13) has been "on the books" for approximately 17 years, its applicability to a number of various situations is only now becoming completely apparent. The ever increasing number of subsidiary organizations created by all types of exempt organizations, especially hospitals, has focused attention on this relatively obscure and somewhat complex statutory provision. It is important to be aware of the existence of IRC 512(b)(13) which serves as an exception to the exclusion from unrelated business taxable income of interest, annuities, royalties and rents derived from controlled organizations. Whenever it appears that an exempt organization is receiving amounts from a subsidiary organization, the first question that should be answered is whether IRC 512(b)(13) is applicable.

Some of the issues involving "control" and the interpretation of the formulas may seem fairly difficult, in part because certain of these issues have not been routinely considered in the past. Nevertheless, as more cases are identified and worked, further experience will be obtained, and our ability to deal with these issues will be increased. Undoubtedly, further refinement with respect to the definition of "control" will occur, and additional guidance might be necessary in order to interpret and apply the complex formulas correctly. Issues concerning controlled organizations that are without published precedent should be referred to the National Office as set forth in IRM 7664.1 and IRM 7(13)(12).